STATE OF CALIFORNIA
CONSUMER POWER AND CONSERVATION FINANCING AUTHORITY

Establishment of Target Reserve Level for the California Power Authority Investment Plan	Rulemaking 2002-07-01

COMMENTS OF THE ALLIANCE FOR RETAIL ENERGY MARKETS ON RESERVE ISSUES

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I.

INTRODUCTION

At the invitation of the California Power Authority ("CPA"), the Alliance for Retail Energy Markets ("AReM") hereby submits these comments on issues relating to the CPA's determination of an appropriate reserve margin on which to base its future investment activities. In February of this year, the CPA adopted an initial reserve margin target of 15%.[1] The CPA instituted this proceeding to determine the definitive reserve margin target that it should use to carry out its statutory assignments regarding adequacy and stability of electric supply in California.[2] For the reasons discussed below, AReM recommends that the CPA adopt a reserve margin target of 12%.

II.

COMMENTS

AReM believes that the reserve margin level adopted by the CPA should be viewed as more of a threshold for public investment in the state's energy infrastructure rather than a target. Accordingly, AReM urges the CPA to adopt a reserve margin target that reflects the minimum level of reserves necessary to ensure system reliability under peak demand conditions while at the same time protecting consumers against market volatility. Only if it appears that private investment will not be sufficient to maintain reserves above the adopted minimum should the CPA take action to increase the state's excess capacity.

AReM recommends that the CPA adopt a definitive reserve margin target (threshold) of 12%. A minimum reserve level of 12% is consistent with the Federal

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[1] Consumer Power Financing and Conservation Financing Authority, *Energy Resource Investment Plan* ("ERIP"), Feb. 15, 2002, at 10.

Energy Regulatory Commission's ("FERC") proposed Standard Market Design & Structure, wherein the FERC determined that reserves of 12% should generally be sufficient to ensure system reliability and market stability.[3] AReM also notes that in Texas, which has one of the most successful restructuring programs in the nation, the Electric Reliability Council of Texas ("ERCOT") staff recently recommended that the state's minimum reserve requirement be reduced from 15.5% to 12%.[4]

AReM is confident that the market will provide reserves at levels comfortably above the adopted minimum. AReM notes that in Texas the reserve margin during peak periods is more than double the state's advisory reserve level.[5] And in other competitive markets, private investment in energy infrastructure is providing reserve margins of 18% and much higher.[6]

Whether the actual target adopted by the CPA is 12% or slightly higher, AReM urges the CPA to be cautious in its actions. AReM is concerned that if the CPA is too aggressive in its investment activities, private investment in new generation will be disrupted. AReM understands that there is a direct correlation between reserve margins and the availability of private financing for new resource development, with financing becoming scarcer as reserve margins approach 18%.[7] Without private financing,

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[2] Notice of Rulemaking ("NOR") 2002-07-01, *mimeo*, at p. 2 (July 24, 2002).
[3] FERC Docket No. RM01-12-000, Standard Market Design & Structure Notice of Proposed Rulemaking, at ¶ 493 (July 31, 2002).
[4] At the August 22, 2002 meeting of the ERCOT Board of Directors, the Board adopted an advisory reserve margin of 12.5%.
[5] Actual reserves in Texas for August 2002 are estimated to be 30.9% compared to the adopted minimum of 12.5%. *See* North American Electricity Reliability Council ("NERC"), *2002 Summer Assessment*, Table 3 (May 2002).
[6] *See* NERC, *2002 Summer Assessment*, *supra* note 5.
[7] While historically private financing may have been available to the utilities to develop new generation resources even when the utilities maintained high levels of planned reserves, that was because the utilities were allowed a reasonable opportunity to recover the costs of those resources in retail rates. Competitive developers have no such assurances, and thus are less able to attract third party financing under depressed market conditions.

resources development could grind to a halt and the state could face real capacity shortages in the very near future. The CPA must be careful not to adopt an overly aggressive investment plan that would send the wrong signals to private investors. To that end, AReM recommends that the CPA consult with the financial community to gain a better understanding of the relationship between reserve margins and the costs and availability of private financing.

III.

RESPONSES TO QUESTIONS POSED IN NOTICE OF RULEMAKING

The NOR for this proceeding identifies five questions that the CPA thinks should be considered in forming a recommendation as to an appropriate reserve margin for the state. AReM's responses to those questions are set forth below.

1. **Considering the fundamental difference between the current generation market and the past, does the historic reserve level reflect the greater reliability risks of the present and future?**

This question assumes that reliability risks are greater now than they were under the traditional market structure. That is not necessarily true. Under a truly open and competitive market structure, new generation resources will be developed in an economically rational manner when and where price signals indicate they are needed. As noted in the discussion above, in other competitive markets the market maintains margins 18% of above, consistent with and even exceeding the levels historically maintained by the utilities. AReM believes that the more the CPA or any other government entity intervenes in the market and distorts price signals, the more reliability will be placed at risk.

2. **Given the recent cancellations and delays, and the uncertainty of the financial community, how many of the proposed plants will actually come on line, and under what terms and conditions?**

AReM cannot speculate how many of the currently proposed plants will actually come on line or under what terms and conditions. However, if the CPA adopts a definitive reserve margin target that is too high it could have a chilling effect on private financing, thus placing those projects that are currently viable at even greater risk of being shelved.

3. **What will the lingering effects of behavioral conservation be, and what are the permanent effects?**

The unprecedented response of California consumers to calls for energy conservation during the summer of 2001 will be the subject of study and marvel for decades to come. Although energy conservation has dropped off in recent months, there is no question that such measures can have a significant impact on peak demand. Rather than fretting about the inevitable decline in consumer consciousness now that the energy crisis is perceived to be a thing of the past, the CPA and other regulators should focus on restoring consumer awareness of energy conservation measures. That is the best way to ensure that conservation becomes a permanent and dependable element of the state's energy plan.

4. **What impact will the significant rate increases have on load and consumption patterns?**

There are too many variables that affect load and consumption patterns for AReM to speculate on the impact of significant rate increases associated with aggressive investment by the CPA projects aimed at expanding the state's excess capacity. AReM believes it makes little sense, however, for the CPA to undertake an aggressive investment program if the market is providing sufficient reserves.

5. **What impact will the new market design elements approved by FERC on 7/17/02 and those still pending have on system loads and procurement practices?**

It is too early to know what the impact of the new market design elements approved by FERC and those still pending will have on system loads and procurement practices. That uncertainty is just one more reason why the CPA should adopt a modest reserve margin target in this proceeding. If the CPA adopts a high reserve margin target and begins to invest aggressively to reach that target, it could distort the market and procurement practices.

IV.

CONCLUSION

For the reasons discussed above, AReM strongly recommends that the CPA adopt a definitive reserve margin of 12% to guide its future investment activities. If the CPA determines that a higher level of reserves is necessary, it should in no event increase the state's reserve margin target above 15%.

Respectfully submitted,

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